

LATE NEWS

Retiree benefits subject of letter

WASHINGTON — The Internal Revenue Service issued a private letter ruling stating an employer, under certain circumstances, may make tax-deductible contributions to even a fully funded pension plan to provide for retiree medical benefits.

Employers with fully funded plans have shied away from establishing retiree medical accounts under Section 401(h) of the Internal Revenue Code because of uncertainty over deductibility of contributions, which may not exceed 25% of aggregate employer contributions to the pension fund.

In its March 23 letter, however, the IRS said an employer who cannot make pension contributions because of full-funding limitations may determine the 25% retiree medical contributions limit by using the cost of contributions, under the projected unit credit actuarial cost method, and other reasonable assumptions regarding medical benefits.

The IRS declined to identify the employer that requested the ruling. It can be used legally only by the employer requesting it, but it does indicate the IRS' general position on an issue.

According to TPF&C, Chicago, the ruling opens an attractive option to employers interested in funding retiree medical obligations to mitigate the effect of proposed accounting changes.

Batterymarch acquires AgriVest

BOSTON — In its first switch away from stock market investing, Batterymarch Financial Management has purchased AgriVest Inc., a Glastonbury, Conn.-based manager of agricultural lands. The purchase price was not disclosed.

AgriVest's President George Schwab, Executive Vice President James McCandless and four other principals will retain their roles in the new affiliate, called Batterymarch/AgriVest Co. AgriVest was formed in 1983 as a spinoff from the agricultural investment division of Connecticut Mutual Life Insurance Co. The firm manages \$325 million in taxable assets.

W. Virginia treasurer impeached

CHARLESTON, W. Va. — The state treasurer was impeached March 29 by the West Virginia House of Delegates for his responsibility in the 1987 loss of \$279 million of the value of the state's \$1.2 billion Consolidated Investment Fund.

The fund is composed of various municipal fire and police pension funds as well as operating assets from various state and local agencies. The fund contains no state pension money.

The 17 articles of impeachment, approved 65-34, allege that Treasurer A. James Manchin didn't provide proper oversight of the fund, improperly delegated authority and violated investment guidelines, according to Mike Mowery, chief counsel for the House Judiciary Committee.

Mr. Mowery said Mr. Manchin is alleged to have allowed staff to invest the fund's assets in securities with maturities exceeding 10 years without receiving the required approval of the State Investment Board and also with investing more than 15% of the assets in reverse repurchase agreements. Mr. Manchin is expected to be tried by the state Senate in May.

Battle between states heats up

HARTFORD, Conn. — Two Connecticut state lawmakers are calling for the \$6.2 billion State of Connecticut Trust Funds to divest of all holdings in New York-based corporations to retaliate against New York state for imposing what they say is an unfair tax on Connecticut commuters.

Since New York Gov. Mario Cuomo enacted a tax on Connecticut commuters last month, the two states have been locked in a fierce tit-for-tat battle. Last week, Connecticut state Sen. Jim Maloney and Rep. Barbara Ireland proposed a tax on New York residents who commute to Connecticut, divestiture of state holdings in New York-based companies and a ban on the purchase of New York-made goods and commodities.

"We're still shell shocked," said Frank McDermott, assistant treasurer of the state pension fund.

Funds select money managers

• LITTLETON, Colo. — The \$24 million Arapahoe County Retirement Fund hired its second investment manager, The Chicago Group, a unit of Morgan Stanley Asset Management, to run \$12 million in a balanced account more heavily weighted toward equities, according to County Treasurer Dorothy Vogt.

The fund's other manager, Denver Investment Advisors, will continue with a \$12 million balanced account, more heavily weighted in fixed income, said Ms. Vogt.

• EDMONTON, Alberta — The \$837.7 million Alberta Government Employees' Pension and Death Benefit fund hired State Street Bank and Trust Co., Boston, to run \$21 million in a Morgan Stanley Capital International Europe Australia Far East index fund, according to Bob Bertram, director of the pension fund.

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Short selling eyed
Funds move slowly

By Trudy Ring

Pension funds are taking a longer look at short selling of stocks, although their participation in this area is still minuscule.

• The Frank Russell Trust Co., a subsidiary of The Frank Russell Co., Tacoma, Wash., has attracted \$42 million from 15 to 20 pension investors since the fall for its commingled fund that incorporates short-selling strategies.

Russell plans to start a similar fund for foundations, endowments and taxable investors, according to Donald J. Hardy, senior vice president.

• Feshbach Brothers, Palo Alto, Calif., a firm that is solely a short seller and manages about 20% of the Frank Russell commingled fund, has about "two or three" additional pension clients, said Joseph Feshbach, general partner of the firm.

Mr. Feshbach said only about 10% of the firm's \$300 million under management, including assets run for Frank Russell, is from pension funds.

• Evaluation Associates Inc., Norwalk, Conn., has a few managers doing shorting in a pooled small equity manager fund it offers to pension sponsors. Between 10% and 20% of the \$800 million-plus fund is involved with strategies that incorporate short selling, said Bill Crerend, chairman.

• At least three large corporate pension sponsors — Allied-Signal Inc., Morristown, N.J.; Chrysler Corp., Highland Park, Mich.; and Owens-Illinois Inc., Toledo, Ohio — are taking very preliminary looks at various short-selling strategies.

The \$4.4 billion pension fund of Chrysler Corp., Continued on page 39



Robert Gordon of Twenty-First Securities says more pension fund officials are taking a serious look at shorting strategies.

Flat yield curve
puts new wood
under ARPS fire

By Fred Williams

The flattening of the yield curve could breathe new life into a short-term investment considered dead for the past two years — adjustable rate preferred stock.

Adjustable-rate preferreds, once a hot item in some short-term portfolios, fell out of favor both as a financing mechanism and as an investment in recent years.

Now, they could benefit if the yield curve remains flat, or returns to a more normal upward curve, as many economists are predicting for later this year.

"Investors will participate fully (with ARPS) if the curve remains flat; there is no yield curve risk right now because rates are already flat," said Craig Hobbs, president and chief investment officer of Composite Research & Management Co., Seattle.

"Conversely, if rates return to a normal upward sloping curve (short-term rates significantly lower than long-term rates), by buying ARPS today at very depressed prices (they have) significant potential for price appreciation."

ARPS — developed in response to the volatile interest rate environment of the late 1970s and early '80s — are similar to regular perpetual preferred stock, but the dividend rate is reset, usually quarterly, at a fixed spread to the highest point on the Treasury yield curve. The reference point is the higher of the three-month Treasury bill discount rate or the 10- or 20-year constant maturity rates.

During an eight-day period in 1983, approximately \$1.7 billion in new-issue ARPS came to market; the market peaked at \$10 billion; then the security faded. ARPS were panned because of

concerns about credit quality of issuers, overly aggressive pricing by investment bankers, 1984 tax law changes that reduced the corporate dividend exclusion deduction to 70% from 85%, and rising interest rates that eliminated many of the perceived benefits.

In the ensuing years, ARPS got battered by the flattening of the yield curve, where short-term rates have risen to nearly the same levels as long-term rates, causing the security to lose significant principal value.

Now, however, ARPS might offer aggressive investors the potential for dramatic principal gains and yields competitive with other short-term vehicles. The key: the direction of interest rates.

"If you believe the yield curve will return to a normal position, the price of ARPS will appreciate substantially just as they have depreciated over the last 12 to 18 months," said Mr. Hobbs.

Outstanding issues of ARPS are priced off the short end of the yield curve, with Treasury bills yielding approximately 8.75%. If short rates decline and long-term rates remain at or above 9%, the reset mechanism would switch the yield to the long-term rate and make ARPS more attractive than other short-term vehicles yielding a market rate.

The "kicker," said Mr. Hobbs, is that should short-term rates once again be lower than long rates, ARPS would regain much of their lost principal value.

Among issuers, First Union Corp., Charlotte, N.C., has announced it will issue approximately \$375 million in adjustable rate preferred to help finance its \$749 million acquisition of Florida National Banks.

ARPS originally were pur- Continued on page 37

Dresdner
pulls out
of ABDI

By Margaret Price

NEW YORK — Dresdner Bank reportedly will close the New York operations of ABD International Management Corp., and will invest in Oechsle International Advisors L.P., Boston.

Dresdner, of Frankfurt, West Germany, owns a 75% stake in ABDI.

Although negotiations between Dresdner and Oechsle are continuing, sources say Dresdner Bank plans to invest, and become a limited partner, in Oechsle through Dresdner Asset Management U.S.A. Corp., a newly created investment holding company.

Dresdner will purchase the interest from limited partners headed by San Francisco investment bankers Hellman & Friedman.

The deal would give Dresdner slightly less than a 50% stake in Oechsle and a link to a large and prominent U.S. international money manager. Dresdner is believed to be planning to acquire at least one other U.S. money management firm.

The Dresdner deal presents Oechsle with an opportunity to work with a bank that has worldwide connections and extensive research facilities.

At the same time, Oechsle's general partners would retain control of the management and investment policies of the firm.

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TRADING

The battle over trading commission dollars — pitting the demands of institutional investors for lower rates against the desire of brokerage firms to maintain profits — might result in a negotiated truce that could radically transform all aspects of the U.S. equity business. Yet, as this struggle nears resolution, institutional investors

still face a number of other trading issues, ranging from the growth of fourth-market trading systems to the use of computers by international stock exchanges. *Pensions & Investment Age* examines these and other recent developments in institutional trading practices here and in a special section beginning on Page 11.

Who controls commission dollars?

	Total institutions		Those generating more than \$5 million	
	1987	1988	1987	1988
Portfolio managers	43%	47%	28%	32%
Security analysts	11	11	10	11
Traders	31	34	45	47
Customers	8	9	8	8

Source: Greenwich Associates, Greenwich, Conn.

Institutions, brokers slowly pull together

By Marcia Parker

Intense and still-building pressures on the financial services industry and its institutional clients are accelerating a tide of change that clearly can't be held back: an overhaul of the U.S. equity business, from product creation to the pricing structure and distribution system on which stock trading is based.

The pressure cooker is prompting the brokerage industry and institutional investors to put an end to their polarization and to work together to find ways to rationalize the business.

Pension fund and brokerage firm executives say there's a long way to go, and they don't agree on all issues, but they are starting to hammer out the issues behind the scenes, trying to fashion a new order to replace a system they agree is outdated for today's global markets.

"There may be a renegotiation of the business, and that is likely to be done with institutional clients, not to them," said Jay Bennett, a consultant at Greenwich Associates, Greenwich, Conn.

All the players agree 1988 was a very bad year for the institutional equity business. Profitability essentially was wiped out. Trading volume, commission revenue and liquidity plummeted. Intraday volatility soared, along with the use of index trading, making already wary investors even more reluctant to return to a market

that never really recovered from the shock of Black Monday. For institutional investors, lackluster returns spurred widespread efforts to hold down costs.

In 1989, the strain will continue to be keen, nudging along the gradual transformation of the equity business.

No one is certain just what the industry will become in the future or how long the transformation will take. But they all agree a new era is coming.

Achieving the restructuring won't be painless. Institutional investors and brokerage firm executives say they are wrestling with ways to understand, measure and trim execution costs, devise a way to unbundle pricing for all products and services, and build a consensus on sensitive issues such as whether commissions are too high or too low and what to do about soft dollar trading.

Both groups are assessing the right mix of services. Brokerage firms are questioning whether they should continue to produce certain kinds of research, and institutional clients are studying exactly what research they want, use and are willing to purchase. They also are analyzing the implications of the dealerization of the market, or the increasing role of investment banks as principals rather than agents, and responses to that trend.

"We are going through a very long process of change that began with negotiated rates," said Louis

Margolis, managing director, Salomon Inc. "The whole commission structure, the traditional distribution system and the infrastructure of secondary trading will undergo change. The market is (creating) and will continue to create new systems and instruments to augment the structure."

Among the likely changes predicted by more than a dozen leading brokerage firm executives and institutional investors interviewed by *Pensions & Investment Age*:

- A new strategic plan for the equity business will be created, one that reflects less of the brokerage industry's reliance on the investment banking business for high profits — though maintaining the supply of investment product — and more of the need for the equity operation to stand alone and prosper without subsidies.

- Products and services will be unbundled, and a new pricing system will replace the existing bundled system.

"The only real reform will come with unbundling," said Greta Marshall, who heads The Marshall Plan, a money management firm in San Francisco. Ms. Marshall is a former executive of the \$40 billion California Public Employees' Retirement System, Sacramento.

- The focus of the debate will shift to the true costs of trading —

Continued on page 38

Grip is getting tighter

Commissions fall, but the war continues

By Joel Chernoff

Brokerage commissions are facing continued pressure, but some institutional investors are starting to think the squeeze is turning into a bear hug.

Commissions paid on agency trades dropped to 9.1 cents per share in 1988 from 13.8 cents in 1980, according to a forthcoming study by Greenwich Associates, Greenwich, Conn. Greenwich projects average commissions will fall to 8.8 cents this year. Some institutions, however, report paying as low as 3 cents a share.

Instead of being Wall Street's favorite customers, large institutional investors are becoming the scourge of the Street and vice versa.

Investors, however, say the trend must be reversed for the benefit of both themselves and Wall Street.

"I'm not sure I could do business at the net rates we are paying," said Cliff Hinkle, executive director of the \$14.4 billion Florida State Board of Administration. "I think commissions are at the low end of the scale."

The stock market is undergoing a major structural change, said Laszlo Birinyi Jr., president of Birinyi Associates Inc., New York. "You can't reduce commissions by 50% and expect that there is no reaction," he said.

But all investors do not agree. "We are not trying to take the profit out of this business, just the costs for services and products we don't want," John L. Dorian, corporate director-equity investments for General Dynamics Corp., St. Louis, told a recent conference sponsored by the Institute for International Research.

Pressure on transaction costs has resulted in a steady decline in commissions since May 1, 1975, when fixed commission rates were deregulated. Institutional commissions dropped by more than 50% by the end of 1977, falling to an average 12.2 cents per share from 26 cents per share.

While the stock market was booming, the pressure on commissions didn't hurt so much. But since Oct. 19, 1987, commission revenue has fallen drastically. Equity commissions generated by large institutions fell 26% during

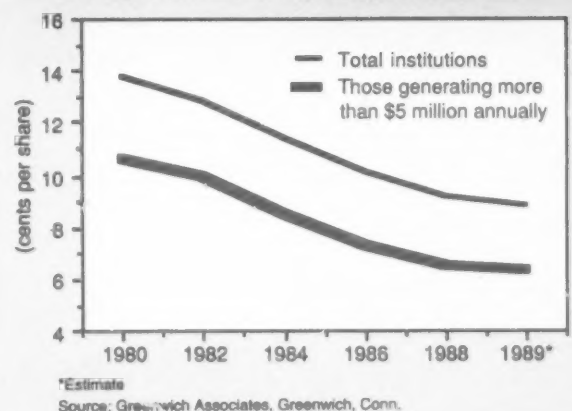
1988, reflecting reduced trading volumes, lower stock prices and continued declines in commission rates, according to Greenwich Associates. While volume has stayed relatively high, at an average of 160 million shares transacted per day from 189 million in 1987, much of it has come from dividend rollover plays or other transactions that do not generate nearly as much profit for Wall Street.

Wall Street firms have been turning to proprietary trading, merchant banking and merger and acquisition activity to make up for lost commission revenue. Commission revenue now accounts for less than 20% of brokerage firm total revenue, down from 49% 15 years ago, according to Securities Industry Association figures.

Meanwhile, pension funds still are squeezing commissions and directing their business elsewhere, further shrinking Wall Street's revenue.

Pension executives see commissions as one of their few controllable costs. In addition, a spotlight brought to bear five years

Average commissions on agency trades



ago on "soft-dollar" payments caused many pension executives to seek a piece of the soft-dollar pie for themselves.

Meanwhile, the sheer growth of pension funds — to \$2 trillion at the end of 1987 from \$891 billion in 1981 — has increased their clout in the capital markets. Institutional assets as a whole more than doubled to \$4.6 trillion in 1987 from \$2.1 trillion in 1981, according to a study by the Columbia University Center for Law and Economic Studies' Institutional Investor Project.

What's more, investors are paying more attention to execution costs — the price they pay for market impact — although investors believe the technology does not yet exist for precise measurement of these costs.

The variety of methods institutional investors have adopted include:

- Institutional investors consistently have increased their use of soft-dollar payments, despite proddings by both the Department of Labor and the Securities and Exchange Commission to unbundle their transaction costs and give up the rebates altogether.

Experts said 25% to 50% of commission dollars are funneled to pay for soft-dollar payments.

For example, CIBA-GEIGY Corp.'s \$947 million pension fund targets 25% of its trades through Rochdale Securities Corp., New York, but does not force its money managers to go through the broker, said William J. McHugh Jr., director of trust funds at the

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New data base aims for clients

By Andrew Reinbach

Institutional Investor magazine is offering a new data base designed to help investment management firms target prospective pension fund clients.

The Investment Management Network is being sold as information that will tell marketers what pension executives are — and aren't — looking for in investment managers.

Forty money managers have purchased the data base; 75 pension executives have completed 32-page questionnaires since the network was formed in January, said Deborah Barron, vice president of market research at Insti-

tutional Investor.

Thirty managers bought the \$9,900 full-service product, which includes at least 250 sponsor profiles, aggregate quantitative analysis, quarterly updates and computer software. Managers purchasing the \$3,750 limited product get 50 sponsor profiles and no software.

The product's main competition appears to be Zzyzx Information Network, Apple Valley, Calif., a 3-year-old computerized data base of plan sponsor information sold to investment managers as a marketing and sales tool. Tom Mollenkamp, president, said Zzyzx contains information from more than 450 public and private funds.

Such services appeal to marketers hoping to gain an advantage over their competitors.

Said Mike Fisher, senior vice president of Banker's Trust Co. — Investment Management Group, New York: "Any service that can increase productivity is a good thing." Banker's Trust, which bought IMN's full-service product, manages \$57.8 billion in tax-exempt assets.

Joe Haley, director of marketing and sales for New York's Chancellor Capital Management Inc., which manages \$17 billion in tax-exempt assets, has looked at IMN, but hasn't bought it yet.

He questioned the value of such data bases. "Buying it in and of itself to create a new marketing approach won't get the job done," he said. "You need a face-to-face meeting to see what (the pension sponsor's) needs are."

Pension executives report no change in the number or kinds of cold calls they're getting from marketers.

"Marketing guys all have their different pitches, and aren't going to change them just because of this information," said Tom Harrison, manager-debts and investment at the \$600 million Memphis City Retirement System.

CORRECTIONS & CLARIFICATIONS

• In the Feb. 20 profile of **Westinghouse Credit Corp.**'s role in the Finlay Fine Jewelry buy-out, it was incorrectly stated that Prudential Insurance Co. supplied financing. Westinghouse Credit Corp. advised the company and supplied all the capital.

• The quarter, one-, three-, five- and 10-year returns for the **Russell 2000 Small Stock Index** published in the March 6 issue were for periods ended Jan. 31. For periods ended Dec. 31, the index returned -0.64% for the quarter, 24.96% for the year, 6.11% for the three years, 7.74% for the five years and 16.83% for the 10 years.

• A March 6 story on **Southmark Corp.** contained several errors.

The \$1.7 billion given as the value of Southmark's real estate excludes hotel and property management companies. The amount of Southmark's 1988 investment in Pratt Hotel Corp. was \$6.8 million. Southmark owns 37% of Pratt, which owns 100% of the Sands Hotel and Casino in Atlantic City, N.J. Under generally accepted accounting principles, a loan from one subsidiary to another does not result in two assets. Also, the number of senior executives at Southmark was, and still is, six.

The Investment Alternative That's A Natural.

First Wachovia's Timberland Fund is an excellent investment vehicle for your pension portfolio. Timberland's low volatility, below average risk, and superior return make it an optimal way to diversify. At First Wachovia, experienced timberland professionals bring a unique perspective to managing your investment by focusing on a

thorough analysis of location, type of timber, and buy/sell opportunities in the life cycle of the forest. To realize the benefits of timberland as an investment, choose an organization with a major commitment to the Southern timberland market. Choose First Wachovia.

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